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Deal in Focus

Detroit Delays Sewer Sale to Make Peace With Michigan

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CHICAGO — The Detroit Water and Sewerage Department has pushed back a $500 million debt issue that was planned for Thursday to give officials time to work through a crippling dispute with Michigan that threatens to bankrupt the city.

The department now plans to come to market next week. Detroit owns the utility systems but they are operated as separate enterprise funds, and most of their revenues come from customers outside the city. Still, the credit faces Detroit-related headline risks heading into the market.

Detroit officials warned Monday that the city faces the prospect of going broke by Friday, forcing it to miss a $34.2 million debt-service payment due that day and falling short of the funds needed for payroll by next week.

The crisis comes as the state has said it would withhold all revenue aid and escrow proceeds unless the city’s top lawyer withdraws a lawsuit challenging the two-month-old consent decree between the Detroit and Michigandesigned to stabilize the Motor City’s wobbly finances.

Detroit water and sewer officials early Tuesday decided to push back their sale by a week to give the city time to make the Friday debt payment. The deal had been set for Thursday and needs to be completed by the end of the month.

The bulk of the issue, $310 million, will go to make swap termination payments to unwind 11 derivative products that hedge $1.4 billion of sewer debt.

The timing is driven in part by a July 1 and July 2 start date on two forward-starting swaps. The cost of terminating the two forward-starting swaps makes up $180 million of the total $310 million termination costs.

Matt Schenk, the chief operating officer and chief compliance officer for the Water and Sewerage Department, said the finance team opted to delay the pricing by a week — it's now tentatively set for next Wednesday — "to allow time for the city and state to work through their resolution of the city's upcoming bond payment. Upon resolution and disclosure of the bond payment to the market, we will proceed with the transaction."

The city itself had hoped to come to market next week with a $137 million refunding deal led by the Michigan Finance Authority that will generate badly needed dollars for the junk-rated city.

That deal needs to be completed by June 27, the mandatory call date on $80 million of notes that the city and the MFA privately placed with Bank of America Merrill Lynch in late March.

The fate of the $137 million MFA deal hinges on a resolution to the dispute between the state and Detroit corporation counsel Krystal Crittendon, who filed the lawsuit challenging the consent decree last week.

The litigation charges that Michigan owes Detroit money, including unpaid state revenue aid, and that state law prohibits agreements between governments when one is in default of another.

Deputy state treasurer Tom Saxton responded with a letter to Detroit chief financial officer Jack Martin arguing that Crittendon's suit essentially challenges all agreements between the city and the state, including bond financings.

Saxton warned Martin that unless the lawsuit was dropped, the state would not complete the $137 million financing or release $35 million from an escrow account that was generated by a recent privately placed bond deal. He said Michigan would also withhold all revenue aid through December to pay off that $80 million private placement.

Detroit's cash flow is so thin that without the $35 million from the escrow account and another $25.1 million in June state aid, the city will go broke by Friday, according to Mayor Dave Bing and Martin.

It would miss a $34.2 million principal and interest payment on the city's pension certificates of obligation and not have enough money to make payroll by next week.

"The state is playing hardball," said a source close to the city. "How can you do a bond deal when there's the threat of default? Would you buy those bonds?"

For sewer system officials, it's ironic that Detroit's fiscal problems are threatening to derail the deal, because the purpose of the financing is to limit its exposure to the city's credit problems. The swaps hedging the sewer debt had termination events triggered last December when Gov. Rick Snyder appointed a fiscal review board to begin to investigate Detroit's finances.

"It's our desire to get out of the risks associated with the city, and that's one of the reasons we're terminating the swaps," Schenk said.

"The swaps still tie the city's credit risk to us through termination events caused by the city that are unrelated to our operations," he added.

The finance team on the sewer deal has been working to distinguish the credit from the city, though it still faces the headwinds of Detroit's headline risks.

In an investor road show, the team touted the department's separate funds, accounts, and financial system, as well as a new bond indenture that features a bond-trustee intercept mechanism and newly expanded rate-setting authority that decouples suburban rates from Detroit City Council oversight.

Echoing similar language in Detroit and Detroit Public Schools' bond documents, the preliminary bond documents for the sewer issue devote a long section to investor concerns, and note that counsel has advised that it is likely, but not certain, that a bankruptcy court would rule that the debt would constitute a special revenue and as such would not be subject to an automatic stay.

"The headline risks do not change the underlying rationale behind why we wanted to do this transaction and why we're pushing forward with it," Schenk said. "We've put protections in place for investors."

In addition to $310 million for swap termination payments, the deal includes $185 million for new projects, and cash for a debt reserve fund and to tender some bonds.

The sewer department entered into 11 swaps starting in 1998 hedging $1.4 billion of debt.

Two of the swaps are so-called mirror swaps, which the city used to avoid termination payments on existing swaps by leaving them in place and bidding out reverse swaps. Two of them are forward-starting that become effective July 1 and July 2, 2012, and have 2039 termination dates.

The counterparties are JPMorgan Chase Bank on two swaps, UBS AG on four swaps and Loop Financial Products on three swaps. Morgan Stanley Capital Services and Siebert Brandford Shank & Co. are each a counterparty on one forward-starting swap. JPMorgan and Siebert are also co-managers on the sewer deal, which is led by Goldman Sachs & Co. and includes BMO Capital Markets.

The upcoming deal includes $500 million of new-money senior-lien bonds plus possibly $75 million or more of refunding senior-lien bonds.

The transaction is tentatively divided into three series, including $179 million of serial bonds, $53 million of term bonds due in 2032 and $343 million of term bonds due in 2039.

Ahead of the deal, Fitch Ratings downgraded all of Detroit’s sewer bonds, which total $3 billion, in part because of the increase of debt from the upcoming sale.

Fitch dropped its rating to A-minus from A on $1.4 billion of outstanding senior-lien bonds and lowered $1 billion of second-lien bonds to BBB-plus from A-minus.

Fitch analyst Douglas Scott said the swap termination converts “a contingent liability into a hard liability, and it severely weakens their debt portfolio.”

On the other side of the coin, Fitch and the other rating agencies noted that terminating the swaps helps the system by eliminating counterparty risk and interest-rate risk and limiting exposure to Detroit’s fiscal problems.

Moody’s Investors Service rates the senior-lien bonds Baa1 and the second-lien bonds Baa2 and has them under review for possible downgrade. The rating agency hit the debt with a three-notch drop in April, citing in part the termination event triggered on the swaps.

Moody's said its future rating action will be decided in part on the city's ability to terminate the sewer bond swaps, develop a plan to pay for the increased debt-service payments from the new debt, and mitigate its exposure to the city's credit.

Standard & Poor's maintains A-plus and A-minus ratings on the senior-lien and subordinate-lien water and sewer debt with a stable outlook. It would be the second time in several months that Detroit undertook a major borrowing to terminate interest rate swaps.

In December, the city sold $500 million of senior-lien water bonds, using about half of the proceeds to unwind 15 interest rate swaps tied to the water debt.

The Water and Sewerage Department also could face a liability tied to interest-rate swaps that hedge $800 million of Detroit pension obligation debt.

A termination event has also been triggered on the pension certificates of participation and, if the counterparties opt to terminate the contracts, the water and sewer systems would likely have to cover a piece of the payment, estimated at $37 million. The city has been negotiating for months with the counterparties — Siebert Brandford Shank and UBS — to try to avoid termination payments, which could be as high as $450 million.

Once the department has successfully shed all 26 of the water and sewer bond swaps, it's unlikely it will enter into similar derivative transactions in the future, according to Schenk.

"We have a fundamentally different governing structure and a new board," he said. "The board has made it very clear that we want to be risk-adverse and have clarity on what kind of financial transactions we're getting into. I think it's unlikely we'd get into swap arrangements in the future."

The Motor City is grappling with the massive swap termination payments at the same time it is trying to fend off a dramatic fiscal meltdown — but that's one of the risks of entering into interest-rate swaps with termination event triggers, said one expert who asked to remain anonymous.

"Unfortunately, it always happens at the worst time," the swap expert said. "It's like if someone lends you money and says, 'Here you go, but if you ever lose your job, you have to pay me back right away.' "

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